MARKET OBSERVATIONS

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The fourth quarter of 2016 (Q4) saw global financial markets driven by two main events: the surprise election of Donald Trump as US President and the increasing certainty of a US interest rate hike at the Federal Reserve's December meeting. The shock November election results sparked a sharp swing in investor expectations towards higher US spending, growth, inflation and interest rates under a Trump administration that lifted US equities and the US dollar, as well as other developed market risk assets. By contrast, bond yields jumped substantially, prompting some to call an end to the 35-year US bond bull market, and emerging market assets also sold off. The Fed's 25 basis point (bp) rate hike and the upward revision to its 2017 interest rate projections further reinforced the "reflationary" outlook. Commodity prices also benefitted, while the successful OPEC (and non-OPEC) member agreement to curtail oil supply sent the price of Brent crude up by nearly 16% to over $56 per barrel by year-end. In South Africa the local market benefitted from an improved outlook thanks to its escape from a sovereign credit rating downgrade and somewhat improving growth and inflation forecasts.

ASSET CLASS	TOTAL RETURN: Q4 2016	TOTAL RETURN: 2016
Global equity – MSCI World Free (US$) (Developed)	2.0%	8.2%
Global equity – MSCI Emerging Markets (US$)	-4.1%	11.6%
Global bonds – Barclays Global Agg Bond Index (US$)	-7.1%	2.1%
SA equity – FTSE/JSE All Share Index	-2.1%	2.6%
SA bonds – BEASSA All Bond Index	0.4%	15.5%
SA listed property – SA Listed Property Index	1.3%	10.2%
SA inflation-linked bonds – JSE CILI Index	-0.9%	6.1%
SA cash (STeFI Composite Index)	1.9%	7.4%

Source: Prudential, Deutsche Securities, data to 31 December 2016

REFLATION IS THE NEW US TREND; MORE SUBDUED ELSEWHERE

In the US, stronger-than-expected Q3 GDP growth of 3.2% (q/q annualised) combined with steadily improving employment data and income growth, as well as slowly rising inflationary pressures, in the fourth quarter to reinforce the widely expected Fed rate hike of 25bps in December. FOMC members incorporated the likelihood of stronger government spending under Trump in their interest rate outlook, lifting their rate expectations to three 25bp increases in 2017, from two previously. In turn, the interest rate market also turned more hawkish, discounting at least another two 25bp increases this year.

The Barclays Global Aggregate Bond Index (US$), a mixture of government and corporate bonds, experienced significant losses during the quarter, with a total return of -7.1% as a result of the sudden sentiment change among investors. The 10-year US Treasury (UST) bond yield weakened about 80bps, rising from around 1.6% to 2.4%. Meanwhile, US corporate bonds benefitted from the improved outlook for the energy sector: investment-grade bond spreads vs USTs declined from about 143bps to 129bps during the quarter, while high-yield bond spreads fell by around 76bps (energy sector bond spreads dropped around 200bps). In the equity market, all three US indices hit record highs near year-end amid the optimism: the S&P 500 returned 3.8%, the Dow Jones 8.7% and the Nasdaq 0.1% for the quarter, making all among the top-performing markets for the year with total returns of 12.0%, 16.5% and 7.3%, respectively.

In the Eurozone, Q3 GDP growth and inflation remained subdued, the former unchanged at 1.6% q/q annualised and the latter at only 0.6% y/y. However, these did mask a generally improving economy in which data surprised to the upside. The ECB announced its intent to extend its monetary easing programme through the end of 2017, but with reduced bond purchase targets, while keeping its main lending rate at 0%. Germany's 10-year bund yield moved back into positive territory at 0.2%, up from -12bps at 30 September. Brexit worries eased somewhat towards year-end on better-than-expected economic data from the UK and some recovery in British markets, with the FTSE 100 returning 4.1% (in US$) in December, but -0.7% for the quarter and -0.2% for the year. Sterling remained weak, spurring more inflation worries for 2017. For Q4, France's CAC 40 returned 3.1% and Germany's DAX 2.6% (both in US$).

In Japan, deflation continued at -0.4% y/y in November, but Q3 GDP growth was better-than-expected at 2.2% q/q annualised (up from 0.7% in Q2), helped by stronger exports and marking a third straight quarter of expansion. The Nikkei 225 Index returned 1.2% over the quarter and 5.9% for the year (in US$).

In China, Q3 GDP growth was reported at 6.7% (q/q annualised) for the third quarter in a row and within the government's 6.5%-7.0% target for the year. The government has emphasised economic stability in 2016, relying on credit expansion to buoy the economy amid some concerns over a weaker property market. The financial market volatility of 2015 has been largely absent due to government controls, with the MSCI China returning -7.1% for the quarter and only 1.1% for 2016 (in US$).

Other emerging market assets, including both bonds and equities, were also sent weaker by the US reflation sentiment during the quarter. Equity losses saw India and South Korea both returning -8.0% and Turkey -13.7%, also hurt by political turmoil. Both Brazil and Russia managed to gain ground in Q4, the latter largely due to the higher oil price, with returns of 2.8% and 18.7%, respectively. These were the top-performing large emerging markets for the year, returning 66.5% and 55.9%. The MSCI South Africa returned -4.0% in Q4 but a respectable 18.4% for 2016 in US dollars.

In commodities, the price of Brent crude oil continued its upward momentum as more non-OPEC members joined the supply agreement, gaining 15.8% in the fourth quarter for a total increase of 52.4% in 2016. Gold lost 12.8% in Q4 and was down 8.1% for the year as its safe-haven status lost its appeal, while platinum fell 12.1% in 2016. Among notable gainers for the year were zinc (60.6%) and tin (45.3%), as well as iron ore, which nearly doubled.

SA AVOIDS DOWNGRADE AMID MIXED RETURNS

In South Africa, it proved to be another volatile quarter with mixed investment returns as the poor global EM sentiment was offset to a certain extent by favourable local developments, the most important of which was the country managing to retain its investment-grade credit rating from all three ratings agencies (albeit moving closer to non-investment grade status). Not only did this support the local bond market, but the premium demanded for South African default insurance fell from +320bps to +284bps (the 10-year credit default swap rate). Despite a deterioration in current economic data, the medium-term macroeconomic outlook improved slightly on the back of diminishing inflationary pressures, a strengthening rand and the increasingly likelihood of no further interest rate hikes. Q3 GDP growth was reported at a disappointing 0.2% (q/q annualised), and November CPI rose to 6.6% y/y, however it was widely believed to have peaked as the impact of the drought continues to dissipate. At its final meeting of the year in November, as in September, the SARB's Monetary Policy Committee (MPC) left rates on hold while again noting that the end of its interest rate hiking cycle was near. However, it set a high bar for any actual rate cuts. The MPC stressed that it saw its main risk coming from a weaker rand due to the uncertain global policy environment under Trump and Brexit. Consequently, there were no interest rate hikes priced into the Forward Rate Agreements (FRAs) market.

Although SA political risk remained elevated during the quarter, investor confidence was bolstered by some successes: the charges faced by Finance Minister Pravin Gordhan were dropped; the Public Protector uncovered evidence of potential corruption in her "State of Capture" report which was made public and led to the resignation of the head of Eskom; and the courts proved able to rein in the other branches of government. Another positive came from the government's Medium-Term Budget Policy Statement in October, which signaled the government's intention to maintain fiscal discipline and drive down the budget deficit over the coming three years, despite slow growth.

In equities, the FTSE/JSE All Share Index returned -2.1% over the three months, for a total return of 2.6% for 2016, its lowest since 2011. For the year, it was the -6.6% recorded by the heavily weighted industrial stocks that dragged the ALSI lower (having started the year at expensive valuations and hurt by the stronger rand, given their significant offshore earnings). Resources shares were by far the strongest performers with a 34.2% total return, while listed property delivered 1.3% in Q4 to return 10.2% in 2016. Financials gained 5.4% for the year.

Nominal bonds ended as 2016's top-returning asset class: the BEASSA All Bond Index delivered a 0.4% total return in Q4 and 15.5% in 2016. Inflation-linked bonds (ILB Composite Index) lost 0.9% in the fourth quarter but returned 6.1% for the year, with the 10-year yield rising about 15bps and 10-year breakeven inflation expected at around 6.8%, little changed from the previous quarter. Cash (the STeFI Composite) delivered a 7.4% return for the year. The rand managed to rebound in December, gaining over 2% versus each of the three major global currencies; for 2016 it gained 11.5% against the US dollar, 26% against UK sterling, and 14.2% versus the euro.

HOW HAVE OUR VIEWS AND PORTFOLIO POSITIONING CHANGED?

In global fixed income, although government bond yields have risen considerably in the US (and to a lesser extent in other developed markets), this was from a very low base and so continue to be expensive. We remain underweight duration and continue to hold cash and shorter-term bonds in order to reduce interest rate risk. We are still positive on both investment-grade and high-yield corporate bonds in the US and Europe relative to government bonds. Losses in global bonds (with government bonds selling off more than the corporate bonds during the quarter) benefited our portfolios, although we now see corporate spreads versus USTs as slightly expensive, rather than at fair value as previously.

For global equities, the rally in many global equity markets (especially the US) has generally brought valuations to levels more expensive than those of South Africa, whereas in Q3 they had been roughly in line. The 12-month forward P/E of the S&P 500 moved up to 17x from 16.8x at the end of Q3, while the FTSE/JSE All Share Index fell to 13.8x from 15.2x. Despite this, we have retained our neutral positioning in global equities in our portfolios as markets remain generally fairly priced. In our global asset allocation portfolios we are neutral equities compared to global bonds and cash. In our higher return-targeting multi-asset funds we continue to be very near our maximum permitted 25% offshore weighting. Our overweight exposures are concentrated in European markets where long-standing growth concerns have kept valuations on the cheap side of fair value, as well as selected Emerging Markets including India, funded by underweights in the US, Japan and a variety of other smaller markets including Australia. In Q4 equity risk premiums (the yield on equities vs bonds) narrowed, but still provide some valuation buffer that should help to protect equities in the event of growth disappointment.

South African equities moved to relatively more attractive valuations over the quarter compared to their long-term fair value, with the FTSE/JSE ALSI 12-month forward P/E falling to 13.8x from 15.2x in Q3. The decline stemmed from three factors: the exit of the expensive SABMiller share from the JSE; upward revisions to corporate earnings expectations; and a fall in share prices (the smallest contributor). Consequently, in our multi-asset funds we have moved from a neutral to an overweight position in local equities on an asset allocation basis. The medium-term prospects for SA earnings to recover to their trend level still depend on an ongoing recovery in commodity prices.

In our domestic portfolios, we remain underweight still-expensive global heavyweights like Aspen and Steinhoff. By contrast, we are holding BAT as one of our top overweights as a solid defensive stock. We also retain our defensive positioning in Resources, being underweight specialist miners like Anglogold and Implats, while preferring more diversified companies like Anglo American and non-mining shares such as Sappi. Financial stocks remain attractive on a risk/reward basis, despite the ongoing risks of a sovereign downgrade. Among our top overweights are Old Mutual, Investec and Barclays Group Africa, and, to a lesser extent, First Rand and Standard Bank. We remain underweight in Retailers, with selective overweights in Foschini and Pick 'n Pay, and prefer to gain our consumer exposure via well-priced consumer services providers like Sun International. On a medium-term valuation basis we prefer Netcare to Mediclinic, and MTN to Vodacom.

In SA listed property, we continue to hold slightly overweight exposure in our multi-asset funds, positioning that has added value over the past 12 months. While the sector recorded good gains during Q4, valuations remain attractive versus ILBs and nominal bonds. In the absence of a material de-rating in the market's valuation, listed property is still priced to deliver double-digit returns over the medium term, comfortably above inflation.

In SA nominal bonds, we added to our modestly overweight positioning in our multi-asset funds during the quarter following the Trump-related sell-off in the local bond market, given the good value on offer. Our multi-asset portfolios have benefitted from our generally overweight bond positioning during the year. Within this, we are also overweight longer-dated bonds versus shorter paper due to the more attractive yields on offer, while retaining our overweight exposure to corporate bonds. With South Africa's interest rate and inflation outlooks improving, risks to bonds and listed property have moderated somewhat, although the possibility of a credit rating downgrade in 2017 is still a real threat. While SA bond spreads have continued to narrow versus USTs, yields are still pricing in an elevated risk premium (with the 10-year yield around 8.9% at year-end). Our SA bond funds also took advantage of the post-Trump sell-off to add to duration, ending the year with a small overweight position: they benefitted from generally being long duration as bond yields rallied through 2016.

Inflation-linked bonds remained somewhat expensive compared to conventional bonds over the quarter, leading us to maintain our underweight in these assets in our multi-asset portfolios. The 10-year break-even inflation rate remained at around 6.8%, still elevated compared to our long-term inflation benchmark of 6.0%.

LOOKING AHEAD

In 2017 South African investors can expect continued volatility amid higher levels of global uncertainty and political risk given the unknown impact of the new Trump administration, as well as Brexit and possible populist election results in France, Germany and the Netherlands. The bullish Trump-related rallies in the US could also prove to be overdone, while US "reflation" could be a cause for concern for emerging markets in the year ahead, with capital flows redirected towards relatively more attractive US assets. Locally, despite the marginally improving outlooks for local inflation, interest rates and growth, material risks remain for a possible credit rating downgrade mid-year. Economic growth remains sluggish and pro-growth reforms difficult to implement. February's 2017-2018 Budget will be the first important indicator of the government's intentions to bring debt ratios down further, as well as its reform plans. ■